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IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BOWATER INCORPORATED AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in determining the source of a multinational taxpayer's income under Treasury Regulation § 1.861-8(e), the interest expense to be allocated and apportioned is net interest expense, that is, gross interest expense minus offsetting interest income.

PARTIES TO THE PROCEEDINGS

Bowater Incorporated has no parent companies. It has two non-wholly-owned subsidiaries: Calhoun Newsprint Company (whose remaining shares are owned by Herald Company, Inc., a non-public company); and Bowater Mersey Paper Company, Ltd. (whose remaining shares are owned by The Washington Post Company, a publicly-traded company).

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PETITION FOR A WRIT OF CERTIORARI

Bowater Incorporated respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-12a) is reported at 108 F.3d 12. The opinion of the Tax Court (App. 17a-28a) is reported at 101 T.C. 207.

JURISDICTION

The judgment of the court of appeals (App. 13a-14a) was entered on March 3, 1997. The taxpayer's petition for rehearing with suggestion for rehearing en banc was denied on June 9, 1997 (App. 15a-16a). On August 26, 1997, Justice Ginsburg extended the time within which to petition for a writ of certiorari to and including October 7, 1997 (App. 40a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of §§ 861(b) and 994(a) of the Internal Revenue Code, 26 U.S.C. ("the Code" or "IRC"), and of §§ 1.-861-8 and 1.994-1 of the Treasury Regulations on Income Tax, 26 C.F.R. (1978) ("Treas. Reg."), as in effect during the tax years in issue, are reprinted in App. 32a-39a.

STATEMENT

1. Section 861(b) of the Code and its accompanying regulations govern the allocation and apportionment of expenses, including interest expense, in computing a taxpayer's domestic-source and foreign-source income. This allocation affects numerous determinations under the Code, most notably the calculation of a taxpayer's foreign tax credit. Here, it arises in determining the taxable income of a domestic international sales corporation ("DISC"). Congress enacted the DISC provisions in 1971 to stimulate exports from the United States by allowing DISCs to defer tax on part of their export income.

Bowater is the parent of a multinational corporate group that produces paper, wood pulp and related forest products. It is the largest producer of newsprint in the United States. During the tax years in issue, Bowater had two subsidiaries, Carolina and Southern, that in turn owned DISCs. The DISCs served as commission agents for those two companies' export sales. Carolina and Southern are referred to as the DISCs' "related suppliers." App. 4a, 19a.

To compute the DISCs' income, Bowater elected the "50/50 combined taxable income" method set forth in § 994(a)(2) of the Code. This method allows a DISC to earn income equal to 50% of the combined taxable income that the DISC and its related supplier derive from export sales. App. 4a, 20a-21a. The regulation defines "combined taxable income" as the DISC's gross receipts from export sales, minus all costs

"definitely related" to export sales and "a ratable part of any other expenses, losses and deductions." Treas. Reg. § 1.994-1(c)(6)(iii). The regulation requires that the allocation between export and other income of these latter expenses, including interest expense, shall be "determined in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8."

The allocation of interest expense is governed by Treas. Reg. § 1.861-8(e)(2). It adopts "the approach that money is fungible and that interest expense is attributable to all activities and property" of the taxpayer. "This approach recognizes that all activities and property require funds," that "management has a great deal of discretion as to the source and use of funds," and that money borrowed for any particular purpose "will generally free other funds for other purposes." Treas. Reg. § 1.861-8(e)(2)(i). The regulation accordingly provides that interest expense, described as "the cost of borrowing," is "allocable to all the gross income which the income-producing activities and property of the taxpayer generate." *Id.* § 1.861-8(e)(2)(i) & (ii). This regulatory scheme will be referred to hereafter as "the fungibility principle."

Carolina, Southern and their DISCs incurred gross interest expense during 1979 and 1980 of $1.4 million and $1.9 million, respectively, on general corporate indebtedness. App. 19a. Carolina and Southern also earned substantial interest income on inter-company loans of surplus cash to their parent. App. 19a-20a.[1] Applying the fungibility principle contained in the governing regulation, Bowater netted the gross interest income of Carolina and Southern against the gross interest expense of

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[1] Under IRC § 482, loans between related taxpayers must bear interest at an arm's-length rate. *See* Treas. Reg. § 1.482-2(a). There is no dispute that the subsidiaries' loans to their parent comported with arm's-length norms. App. 20a n.1.

Carolina, Southern, and their DISCs in order to determine the actual cost of those companies' borrowing. Bowater then allocated the resulting net interest expense — approximately $250,000 in 1979 and $140,000 in 1980 — between export and other income in computing the taxable income of the DISCs.

On audit of Bowater's tax returns, the Commissioner determined that the regulations require allocation of gross, rather than net, interest expense. By increasing the interest expense charged against export receipts, the Commissioner substantially reduced Bowater's tax-deferred DISC income, generating tax deficiencies of $320,400 in 1979 and $686,700 in 1980 attributable to this issue. App. 5a.

2. Bowater sought redetermination of the deficiencies in the Tax Court, which ruled for the taxpayer. Following the Fifth Circuit's decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), the Tax Court held that the amount of interest expense to be allocated under Treas. Reg. § 1.861-8(e)(2) is net interest expense.

In the Tax Court, "both parties recognize[d] that this regulation does not expressly state whether or not netting of interest is allowed." App. 23a. The Court noted, however, that the regulation requires allocation among the taxpayer's various activities of "the cost of borrowing." *Id.*, quoting Treas. Reg. § 1.861-8(e)(2)(i). According to the Tax Court, "[n]et interest expense is the actual cost of borrowing," namely, "interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus." App. 26a-27a.

In holding that net interest expense is "the total cost of borrowing" (App. 26a), the Tax Court adopted the reasoning of the Fifth Circuit in *Dresser*. As the Fifth Circuit explained, businesses (other than banks) typically borrow money not to earn interest income, but rather to finance their operations. "To

reduce the cost of holding [borrowed] funds until they are actually needed," a corporation will typically invest in short-term, interest-bearing instruments. And because it may be impractical to retire long-term obligations prior to maturity, a business "will typically invest any cash surplus to offset the cost of carrying its long-term debt." *Dresser*, 911 F.2d at 1135, quoted in App. 25a. "In either case," the Fifth Circuit held, "the total *cost of the borrowing* is the interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus." 911 F.2d at 1135 (emphasis original), quoted in App. 25a.

The Tax Court concluded that netting interest income against interest expense faithfully implements the fungibility principle of Treas. Reg. § 1.861-8(e)(2) "because both focus on the underlying economic realities." According to the Tax Court, "[n]etting of interest avoids unequal treatment of taxpayers with the same amount of actual interest cost, just as the fungibility of interest concept avoids unequal treatment of taxpayers whose indebtedness is structured differently." App. 24a. The Tax Court found that the Commissioner's contrary position not only ignores the realities of corporate borrowing, but illogically "assumes its own conclusion: that interest income should be considered separately, and not netted with interest expense." App. 25a. Because "net interest is the actual cost of borrowing," the Tax Court held that the Commissioner's proposed gross-interest allocation would improperly "burden a DISC with a disproportionate share of the actual borrowing costs of all operations." App. 26a.

3. The court of appeals reversed (App. 3a). It declined to follow the Fifth Circuit's decision in *Dresser*, adopting instead the Commissioner's position that Treas. Reg. § 1.861-8(e)(2) requires allocation of gross, rather than net, interest expense.

According to the court of appeals, the Fifth Circuit in *Dresser* "relie[d] on its own judicial version of 'economic reality' to justify allocation of interest expense to interest income before any remaining interest expense is allocated to other income producing activities." App. 7a-8a. "Whatever might be said about *Dresser's* theory of the 'true cost of borrowing,'" the court of appeals concluded that the Fifth Circuit's theory "does not comport with the Regulation's concept that money is fungible." App. 8a. The Second Circuit emphasized the regulation's requirement that the cost of borrowing be allocated to "all income producing activities" of the taxpayer, which it interpreted to include the activity of producing interest income. App. 5a. It accordingly held that "Taxpayer's — and *Dresser*'s — version of the 'true cost of borrowing' has no basis in the Regulation." App. 9a. "In any event," the Second Circuit stated that "the plain language of the Regulation does not give us the latitude to interpret it based on impressions of how businesses 'typically' conduct their affairs, or on economic theories of what constitutes 'the true cost of borrowing.'" *Ibid.*

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates a direct conflict among the circuits on an issue of substantial importance in international taxation. The proper method for apportioning interest expense is not limited to computation of DISC income; to the contrary, it arises in a large number of distinct tax settings, all of great significance to multinational taxpayers. The question presented is now pending in numerous IRS audits involving very substantial tax liabilities, and decision of this issue will ultimately affect the tax liabilities of virtually all U.S.-based multinational corporations. Resolution of this important, recurring question is needed to avoid continuing

uncertainty, to prevent repetitive and wasteful litigation, and to ensure even-handed application of the tax laws.

1. The decision of the Second Circuit in this case directly conflicts with the decision of the Fifth Circuit in *Dresser*, 911 F.2d 1128. The Fifth Circuit in *Dresser* squarely held that net interest expense represents the actual cost of borrowing; it accordingly interpreted Treas. Reg. § 1.861-8 to require that net interest is the amount of interest to be allocated to various categories of income. By contrast, the Second Circuit in this case dismissed "*Dresser*'s theory of 'the true cost of borrowing'" and held that the regulation requires allocation of gross interest expense unreduced by interest income. App. 8a.

The two decisions conflict, not only in their holdings, but also in their underlying rationales. Whereas the Second Circuit believed that "[t]he plain language of Treasury Regulation § 1.861-8(e)(2) controls the outcome" (App. 5a), the Fifth Circuit in *Dresser* found the regulation to be inexplicit or ambiguous. While agreeing that the regulation, given a literal reading, does not expressly require netting, the Fifth Circuit observed that "the same literal reading does not preclude such an approach" either. *Dresser*, 911 F.2d at 1134-1135. The Fifth Circuit accordingly considered Congressional purpose, legislative history, and the economic realities of corporate borrowing in deciding that "the cost of borrowing," as that term is used in the regulation, should be interpreted to mean *net* rather than *gross* interest expense.

This conflict among the circuits is no less direct because the two courts of appeals considered different versions of the regulation. The tax years at issue in *Dresser* were 1976-1977, and that case was accordingly controlled by Treas. Reg.

§ 1.861-8(a), originally promulgated in 1957.[2] However, there is no meaningful difference between the two versions of the regulation in terms of the question presented here. Both versions require the apportionment of interest expense to all categories of gross income. And neither version of the regulation specifies whether the "interest expense" to be apportioned is *net* or *gross* interest expense.

The strength of this conflict is underscored by the fact that the Fifth Circuit in *Dresser* specifically relied upon Treas. Reg. § 1.861-8(e)(2) — the version of the regulation at issue here — to support its conclusion that netting of interest is required. The Fifth Circuit had previously decided a case involving the allocation of interest expense to "gross income from mining" for purposes of computing a taxpayer's depletion allowance under IRC § 613. *See General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981). In *General Portland*, the court reasoned that the amount of interest to be apportioned is the taxpayer's "actual cost for interest on borrowed funds," and it held that a "[t]axpayer's actual cost for interest is its 'net' interest expense." 628 F.2d at 344. In deciding that the same analysis

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[2] The version of the regulation considered by the Fifth Circuit in *Dresser* provided as follows:

> From the items of gross income specified in §§ 1.861-2 to 1.861-7, inclusive, as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income.

Treas. Reg. § 1.861-8(a) (as amended in 1975). Section 1.861-8(e) of the regulations, which governs the instant case, was promulgated in 1977, applicable to tax years beginning after December 31, 1976. *See* Treas. Reg. § 1.861-8(a)(5)(ii).

should apply in *Dresser*, the Fifth Circuit specifically relied on the subsequent version of the regulation that is involved here (911 F.2d at 1135):

> In providing for the allocation and apportionment of interest under code section 861, the current Treasury Regulations take the approach that money is fungible. *See* Treas. Reg. § 1.861-8(e)(2)(i) (as amended in 1988). According to the regulations, "[t]his approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds." * * * Although the current Treasury Regulations are not controlling in the case at bar, this particular passage does illustrate the fundamental principle we expounded in *General Portland.*

On the Fifth Circuit's view, Treas. Reg. § 1.861-8(e)(2) simply made explicit the fungibility principle inherent in the earlier version of the regulation, and the court held that this fungibility principle dictates that net interest is the amount of interest to be allocated under § 861.

Thus, the Fifth Circuit in *Dresser* expressly considered the version of the regulation involved in the instant case and concluded that this version is consistent with — indeed, supports — its conclusion that netting of interest is required under the § 861 regulations. In so doing, the Fifth Circuit made clear that it would interpret both versions of the regulation in the same way. There can accordingly be no doubt that the Fifth Circuit would decide the instant case in a manner opposite to that in which the Second Circuit decided it, and hence that the two decisions are in direct conflict.

2. In refusing to follow *Dresser*, the Second Circuit has injected confusion into a body of tax law that had been well-settled until now. The question whether interest expense

should be allocated to classes of income on a gross or a net basis first arose in the depletion context. *See General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), *cert. denied*, 450 U.S. 983 (1981). As noted earlier, the Fifth Circuit there held that netting is required because the "[t]axpayer's actual cost for interest is its 'net' interest expense." 628 F.2d at 344. The Tax Court reached the same conclusion in a subsequent depletion case. *See Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352, 402 (1984). The Commissioner explicitly acquiesced in both of those decisions. *See* IRS Actions on Decision 1986-022 & 1986-023 (Feb. 26, 1986), *reprinted in* 1986 IRS Positions Rptr. (CCH) ¶¶ 44,022 & 44,023.

The Fifth Circuit in *Dresser* subsequently ruled that net interest is likewise the amount of interest required to be allocated under the § 861 regulations. And *Dresser* has been followed by the Tax Court, not only in the instant case, but in two other opinions authored by different judges. *See The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996); and *Computervision Int'l Corp. v. Commissioner*, 71 T.C.M. (CCH) 2451, 2465 (1996). On each occasion, the Tax Court has held that the fungibility principle enunciated in *Dresser* and expressly set forth in the regulation involved here dictates that net interest is the amount of interest to be allocated under § 861.

In holding that the regulation "is clear on its face" and that "*Dresser*'s * * * version of the 'true cost of borrowing' has no basis in the Regulation" (App. 5a, 9a), the Second Circuit has departed from this well-established body of law. It has thus reached a result at odds, not only with the Fifth Circuit and the fungibility principle, but also with business realities and common sense. As the Fifth Circuit explained in *Dresser*, businesses other than financial institutions do not borrow

money to generate interest income, but rather to finance their operations. 911 F.2d at 1135. If a business has a temporary cash surplus, it may use this cash to retire debt; but that course of action may be undesirable for any number of reasons, including the high transaction costs incident to retiring long-term obligations. Instead of retiring debt, the taxpayer may opt to reduce its overall cost of borrowing by placing surplus funds in temporary interest-bearing instruments. The Fifth Circuit correctly concluded that the tax consequences should not depend on which course of action a corporation chooses.

Section 1.861-8(e)(2) of the Treasury Regulations recognizes that a company's management has great flexibility in the timing and total amount of borrowing and in deciding the potential uses for borrowed funds. The Fifth Circuit properly interprets this fungibility principle in a way that achieves equality between similarly-situated taxpayers. A taxpayer that chooses to retain larger amounts of debt, yet reduce the cost of that borrowing by earning interest on temporary cash investments, should receive the same results under Treas. Reg. § 1.861-8(e) as the taxpayer that uses cash to retire debt. In either case, the taxpayer's actual cost of borrowing is its net interest expense.

The economic logic of the Fifth Circuit's approach is vividly illustrated by the facts of the instant case. The interest income earned by Bowater's two subsidiaries derived principally from short-term inter-company loans to their parent corporation. *See* App. 19a-20a. Instead of loaning the cash to their parent, the subsidiaries could have used the money to pay off third-party debt, particularly short-term lines of credit used for operating capital. In that event, they would have had virtually no interest income, and their "gross" and "net" interest expense would have been substantially identical.

As *Dresser* and its progeny properly hold, the fungibility principle contained in Treas. Reg. § 1.861-8(e)(2) dictates that the tax consequences should not differ depending on the vagaries of taxpayers' debt structures and cash-management practices. Bowater here borrowed short-term funds from its subsidiaries, resulting in a smaller amount of debt being carried by them and a larger amount of debt being carried by it. If indebtedness is treated as fungible in making interest allocations — as the governing regulation requires — the export income earned by the subsidiaries and their DISCs should not fluctuate depending on the particular application of funds that prudent cash management dictates. The netting of interest income against interest expense eliminates this fluctuation and thus achieves the uniform outcomes contemplated by the fungibility principle of Treas. Reg. § 1.861-8(e)(2).

3. The question presented is very important, in a highly practical sense, to orderly administration of the tax laws. The allocation of interest expense to domestic-source and foreign-source income under § 861 affects a multiplicity of computations under the Internal Revenue Code. The proper allocation procedure is crucial, for example, in computing the foreign tax credit, which has a major effect on the tax liability of all U.S. companies with significant overseas operations. In 1994, U.S. taxpayers claimed foreign tax credits aggregating in excess of $25 billion. *See* Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997).

The amount of a company's creditable foreign taxes is affected by its foreign-source income, and foreign-source income in turn is determined by the amount of interest and other expenses charged against such income. The proper allocation of interest expense thus affects computation of the "overall limitation" on the foreign tax credit (Treas. Reg. § 1.-904-1(b)(1)), the "separate limitations" on the credit (Treas.

Reg. § 1.904-4(c)(2)), the "look-through rules" applicable to transactions with related parties (Treas. Reg. § 1.904-5(c)(2)(ii)), and the determination of "overall foreign losses" (Treas. Reg. § 1.904(f)-1(c)(3)). Companies that conduct oil and gas operations abroad must apply Treas. Reg. § 1.861-8(e) to compute taxable income or loss from various categories of foreign income, which critically affects the magnitude of their foreign tax credit. *See* Treas. Reg. § 1.907-1(f)(2) & 2(d)(2). In 1992, taxpayers engaged in oil and gas extraction claimed foreign tax credits in excess of $450 million. Internal Revenue Service, 15 Statistics of Income Bulletin 117, Table 1 (Winter 1995-1996).

Resolution of the question presented is also of critical importance to a variety of entities that have been created with great frequency in recent years to take advantage of legislative tax incentives. The methodology for apportioning interest expense under § 861 affects multiple computations that must be made by "foreign sales corporations" ("FSCs"). *See* Treas. Reg. § 1.921-3T(b) (determination of foreign trade income); *id.* § 1.921-3T(d)(3)(ii) (determination of separate foreign tax credit limitation); *id.* § 1.925(a)-1T(c)(6)(iii)(D) (determination of total costs related to FSC gross receipts). The question presented affects "possessions corporations" established in Puerto Rico and other U.S. possessions in much the same manner as it affects the DISCs involved here. *See* Treas. Reg. § 1.936-6(b)(1)(Q&A1); *The Coca-Cola Company & Subsidiaries v. Commissioner*, 106 T.C. 1, 4, 31 (1996) (following *Bowater* and holding that net interest expense is the amount of interest to be allocated in determining income of § 936 affiliate). In 1994, U.S. taxpayers claimed possessions tax credits aggregating in excess of $3.7 billion. Internal Revenue Service, 16 Statistics of Income Bulletin 204, Table 13 (Spring 1997). Finally, the § 861 apportionment methodology affects computation of the interest income included in the

earnings of a "passive foreign investment company," to list just one more example. *See* Proposed Treas. Reg. § 1.163(j)-4(d)-(2)(ii).

The question presented is thus important to virtually all U.S.-based multinational corporations in a variety of different ways. Unless the existing circuit conflict is resolved, litigation in all these areas may be expected to increase dramatically as taxpayers outside the Second Circuit rely on *Dresser* and a consistent line of Tax Court decisions as "substantial authority" for computing their tax liabilities on a net-interest basis.[3] Meanwhile, taxpayers in the Second Circuit will be required to use a gross-interest allocation by virtue of the panel's decision in this case.

The question presented not only affects a large number of taxpayers in a great variety of ways; it also involves very significant amounts of revenue. In a limited survey of approximately 100 companies conducted by a leading trade association, more than half the respondents indicated that the interest-allocation issue is currently being raised on audits of their tax returns, with this issue involving aggregate tax liabilities in the range of $65 million. These controversies span years from 1979 to the present and thus concern the proper allocation of interest expense under three distinct versions of the governing regulation.

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[3] If a taxpayer has "substantial authority" for its treatment of an item on its tax return, it has a complete defense to the § 6662 "accuracy-related penalty" with respect to that item, even if the taxpayer does not disclose the relevant facts on the return. *Compare* IRC § 6662(d)(2)(B)(i) *with* IRC § 6662(d)(2)(B)(ii)(I). This means that taxpayers may in effect "play the audit lottery" by claiming net-interest treatment on their returns, without fear of penalties if their position is detected and challenged by IRS on audit.

In 1988, the Treasury Department again amended § 1.861-8 of the regulations, effective for tax years beginning after December 31, 1986. These new temporary regulations continue the fungibility principle, using language identical to that used by the regulation involved here. However, the amended regulation includes an additional sentence stating: "The term interest refers to the gross amount of the interest expense incurred by a taxpayer in a given year." Temp. Treas. Reg. § 1.861-9T(a). The Justice Department in this case informed the court of appeals that the new temporary regulation "simply serves to clarify the Commissioner's position" and that "the concept of fungibility did not change from one iteration of this regulation to another." Brief for the United States at 11, *Bowater, Inc. v. Commissioner*, 108 F.2d 12 (2d Cir. 1997). The Second Circuit agreed that "the temporary regulation merely reiterates, or clarifies, the Regulation at issue here" and found no evidence that it "substantially changed the rules for the apportionment of interest expense." App. 12a.

For all these reasons, the new temporary regulation has little impact on the legal analysis involved in deciding the question presented here. By the same token, this Court's decision of the instant case would provide crucial guidance for courts called upon to interpret the temporary regulation in the future. Ultimately, the courts will have to decide the proper interpretation of the regulations. Unless this Court resolves the existing circuit conflict, there will be many years of wasteful litigation and increasing inequities among taxpayers depending on their circuit of residence.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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Appendix

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT.

No. 335, Docket 96-4039.

BOWATER, INC. AND SUBSIDIARIES,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Argued Sept. 30, 1996.

Decided March 3, 1997.

Commissioner of Internal Revenue appealed decision of the Tax Court, John O. Colvin, J., allowing corporate taxpayer to net interest income against interest expense before allocating interest expense to combined taxable income of taxpayer and its wholly owned domestic international sales corporations (DISC). The Court of Appeals, William A. Norris, Circuit Judge, sitting by designation, held that taxpayer was required by regulation to allocate interest expense ratably to all income producing activities to calculate combined taxable income of taxpayer and DISC.

Reversed.

Robert T. Carney, Washington, DC (Fulbright & Jaworski, Washington, DC, on the brief), for Petitioner-Appellee.

David E. Carmack, Attorney, Tax Division, Department of Justice, Washington, DC (Loretta C. Argrett, Assistant Attorney General, Gary R. Allen, Pamela C. Berry, Attorneys, Tax Division, Department of Justice, Washington, DC, on the brief), for Respondent-Appellant.

Before: KEARSE, NORRIS [1], and LEVAL, Circuit Judges.

WILLIAM A. NORRIS, Circuit Judge:

This appeal requires us to interpret a Treasury regulation that was in effect during the tax years 1979 and 1980. The Regulation provides in part: "[T]he aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate." 26 C.F.R. § 1.861-8(e)(2)(ii) (1978).[2] In *Dresser Ind., Inc. v. Commissioner,* 92 T.C. 1276, 1286, 1989 WL 64601 (1989), the Tax Court interpreted the Regulation in favor of the Commissioner, reasoning that the Regulation spoke of

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[1] Honorable William A. Norris, of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

[2] We refer to § 1.861-8(e)(2) of the 1978 Treasury regulations as "the Regulation." The relevant portion of the Regulation provides in full:

> § 1.861-8 Computation of taxable income from sources within the United States and from other sources and activities. . . .
>
> (e) Allocation and apportionment of certain deductions
>
> (1) In general. Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense. . . .
>
> (2) Interest
>
> (i) In general. The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purposes for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a

allocating interest expense among all income producing activities, including activities that produce interest income, and did not provide "for the netting of interest income and expense before allocation and apportionment." *Id.* at 1285-86. The Tax Court's decision in *Dresser* was reversed by the Fifth Circuit. *Dresser Ind., Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990). In this case, the Tax Court followed *Dresser* without question. We think the Tax Court had it right the first time, and we reverse its decision for the taxpayer.

I

Bowater, Inc. (Taxpayer) is a domestic corporation that produces wood pulp and other related products for sale to customers. During 1979 and 1980, Taxpayer wholly owned Bowater Southern Paper Corporation and Bowater Carolina Corporation. Southern Paper and Carolina Paper, in turn, wholly owned other corporations that qualified as domestic international sales corporations (DISCs) under § 992(a)[3] of

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> taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.
>
> (ii) Allocation of interest. Except as provided in subdivisions (iii) and (iv) of this subparagraph [Note: These exceptions are not applicable here.], the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

26 C.F.R. § 1.861-8(e)(2)(i) & (ii) (1978).

[3] All statute references are to the Internal Revenue Code of 1954 in effect during the tax years in issue.

the Internal Revenue Code.[4] During the relevant tax years, income from export sales that qualified as DISC income received highly preferential tax treatment in that DISC income escaped corporate tax and was taxed solely to its shareholders, with a portion of that tax deferred. *See* 26 U.S.C. §§ 991, 995(b), (c).

To compute the amount of its DISCs' income, Taxpayer used the "50/50 combined taxable income" method set forth in § 994(a)(2). This method limits a DISC's taxable income to 50% of the "combined taxable income" (CTI) of the DISC and its related supplier attributable to export sales. The regulations pertaining to § 994(a)(2) provide that the expenses to be deducted from gross receipts in calculating CTI shall be determined in a manner consistent with § 1.861-8 of the regulations. 26 C.F.R. § 1.994-1. Accordingly, as the parties agree, we must interpret § 1.861-8 to decide this case.

In 1979 and 1980, Taxpayer filed consolidated federal income tax returns with its DISCs and their related suppliers. In the returns, Taxpayer computed the CTIs of its DISCs and their related suppliers by first allocating interest expense to interest income before allocating a portion of the remaining interest expense to income generated by the sales of export property through the DISCs. The effect of computing the CTIs in this manner was to reduce the portion of Taxpayer's taxable income that was not related to DISC export sales, thereby increasing the portion of Taxpayer's taxable income that was attributable to DISC export sales, which in turn increased the portion of taxable income subject to the highly preferential tax treatment afforded to DISC income. The Commissioner claims that in shifting interest

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[4] The names of the DISCs are Southern Export Corporation and Carolina Export Company. For convenience, we refer to them as "DISCs," and to Southern Paper and Carolina Paper as their "related suppliers."

expense away from DISC income in order to maximize DISC income entitled to preferential tax treatment, Taxpayer accumulated tax deficiencies of $320,400 in 1979 and $636,700 in 1980.

II

The Commissioner argues that Treasury regulation § 1.861-8(e)(2) is clear on its face, and requires a taxpayer to allocate interest expense ratably to *all* income producing activities, including activities that produce income in the form of interest. As the Tax Court did in *Dresser,* we agree with the Commissioner.

The plain language of Treasury regulation § 1.861-8(e)(2) controls the outcome of this case. The Regulation provides that "interest expense is attributable to *all* activities and property regardless of any specific purposes for incurring an obligation on which interest is paid," 26 C.F.R. § 1.861-8(e)(2)(i) (emphasis added), and "the aggregate of deductions for interest shall be considered related to *all* income producing activities and properties of the taxpayer and, thus, allocable to *all* the gross income which the income producing activities and properties of the taxpayer generate," 26 C.F.R. § 1.861-8(e)(2)(ii) (emphasis added). Interest is plainly a form of income, and activities that produce interest are plainly income producing activities. Thus, the Regulation requires that the aggregate of deductions for interest be allocated ratably to interest income on the same basis as it is allocated to *all* other income producing activities. The plain language of the Regulation allows for no exception.[5]

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[5] The Commissioner also finds support for its position in the legislative history of § 994(a)(2). Taxpayer argues that this provision is ambiguous and does not help to resolve the issue of whether interest expense should be allocated first to interest income before the remaining interest expense is allocated to income from other income producing activities. We agree with Taxpayer.

Taxpayer would have us amend the language "all income producing activities" to "all income producing activities except those that produce income in the form of interest." As the Commissioner argues, "*all* income producing activities" includes all activities that use money to produce income, including income called "interest," "dividends," "rent," etc. "Interest" is nothing more than a label to describe income earned by putting money to work by selling its time value to others. Similarly, "dividend" is nothing more than a label to describe income earned by putting money to work by investing it in shares of stock. In the eyes of the law, there are important differences between debt and equity investments, but these differences are of no consequence for the purpose of Treasury regulation § 1.861-8(e)(2). What is of consequence is that both investments are income producing activities. That is, both involve the use of money to produce income, and the Regulation requires that deductions for interest expense be allocated to all income producing activities, with no distinction based on whether the income produced bears the label "interest" or "dividend" or any other appellation.

III

A

Taxpayer seizes upon an expression used in the Regulation—that "money is fungible"—to support its interpretation that the Regulation permits the allocation of interest expense first to interest income. This is ironic because the Regulation uses the concept that "money is fungible" to explain its mandate that interest expense be allocated to *all* income producing activities, and now Taxpayer wants us to use the same concept to amend the Regulation to create an exception to that very mandate. The Regulation uses the concept that "money is fungible" to explain why interest expense should be allocated across the board to all income producing activities:

> This approach [that money is fungible] recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. . . . When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer extrapolates from the concept that money is fungible, the doctrine that "only *interest* [is] fungible." *See* Appellee's Br. at 19 n.19. According to Taxpayer, "these Regulations apply only to interest, and do not purport to make interest fungible with dividends, royalties, or any other form of income." *Id.* In other words, Taxpayer interprets the Regulation to mean that money paid in the form of interest expense is fungible only with money earned in the form of interest income, so the two sums must be balanced against each other to determine the amount of interest expense to be allocated to other forms of income. We find no support in the language of the Regulation for Taxpayer's argument. The Regulation says that *all* money is fungible, without exception for money that comes in as interest or goes out as interest, and uses this concept of fungibility to explain why interest expense must be allocated to all income producing activities. *See* 26 C.F.R. § 1.861-8(e)(2)(i). Taxpayer's tortured application of the principle that money is fungible does not justify amending the Regulation to provide an exception for interest income.

B

The only case Taxpayer relies on to support its position is *Dresser*, 911 F.2d at 1128.[6] In *Dresser*, the Fifth Circuit

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[6] *Dresser* arose under an earlier version of the regulations that was much less clear than the Regulation at issue here. While the Regulation

relies on its own judicial version of "economic reality" to justify the allocation of interest expense to interest income before any remaining interest expense is allocated to other income producing activities.

Dresser's version of "economic reality" posits that a business typically borrows money in a single transaction to finance its operations, even though some of the borrowed funds are not required for immediate use. *Id.* at 1135. To reduce the cost of holding these borrowed funds until they are actually needed, *Dresser* reasons, a business might invest in short-term, interest bearing instruments. *Id.* Thus, *Dresser* concludes, the "true cost of borrowing" to be allocated to all operations equals the interest expense on the debt incurred, reduced by any interest earned on the investment of any temporary cash surplus in interest bearing instruments. *Id.* at 1133, 1135.

Whatever might be said about *Dresser*'s theory of the "true cost of borrowing," it does not comport with the Regulation's concept that money is fungible. Taxpayer's reliance on *Dresser* is, therefore, misplaced. *Dresser* posits that interest expense is more related to interest income than it is to income by any other name. Yet, under the Regulation's concept that money is fungible, a cash surplus is simply available cash, and available cash from one income producing activity is interchangeable with cash from any other income producing activity. Indeed, cash positions may change daily, even hourly, as cash flows in from an array of sources, not just from interest bearing sources, and flows out to pay an array of expenses, not just interest expense. As the

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applicable to Bowater's case specifically states that interest expense "shall be considered related to *all* income producing activities," the regulation applicable in *Dresser* used the general language that "[f]rom the items of gross income . . . there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto." *See Dresser,* 911 F.2d at 1134 (quoting 26 C.F.R. § 1.861-8(a) (1975)).

Regulation recognizes, management has a great deal of flexibility as to the source and use of its available funds, 26 C.F.R. § 1.861-8(e)(2)(i), and the management of these funds is a complicated process which the Regulation does not reduce to a single linear cash flow.

The Regulation posits that "all activities and property require funds," *id.*, and that every business activity ties up money that could otherwise be used to reduce debt, and thereby reduce interest expense. In other words, the Regulation implicitly takes the approach that all income producing activities contribute to the cost of borrowing money simply by tying up funds, and that investment in interest bearing securities is no different from investment in other income producing activities, such as stocks, new plants and equipment, inventory, etc., in this respect. Thus, Taxpayer's—and *Dresser*'s—version of the "true cost of borrowing" has no basis in the Regulation.

In any event, the plain language of the Regulation does not give us the latitude to interpret it based on impressions of how businesses "typically" conduct their affairs, or on economic theories of what constitutes the "true cost of borrowing."

The Commissioner argues that we should decline to follow *Dresser* because we should give deference to the Internal Revenue Service's interpretation of the Regulation, as announced in an "Action on Decision" published in response to the Fifth Circuit's decision in *Dresser*. *See Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 510-12, 114 S.Ct. 2381, 2386, 129 L.Ed.2d 405 (1994). In that Action on Decision, the IRS expressly disagreed with *Dresser*, but noted that *Dresser* involved an earlier version of the regulations and stated its position that "section 1.861-8(e)(2) do[es] not provide for the netting of interest income and interest expense before allocation and apportionment." *In*

re: Dresser Ind., Inc., v. Commissioner, AOD 1991-011 (July 15, 1991). Taxpayer argues that we should not give deference to the IRS's interpretation because it amounts to no more than a self-serving litigating position. *See Bowen v. Georgetown University Hospital*, 488 U.S. 204, 213, 109 S.Ct. 468, 474, 102 L.Ed.2d 493 (1988). Because we believe the Commissioner's interpretation is supported by the plain language of the Regulation, we do not rely on a rule of deference.

IV

Taxpayer argues that the government's position would create an anomaly in the tax law between a business that borrows just enough funds to cover immediate needs, and a business that borrows funds to cover future needs while investing the cash surplus in the interim. *Dresser* makes no reference to such an anomaly, and Taxpayer offers no authority for its position. Under Taxpayer's characterization of the Commissioner's reading of the Regulation, the first business would be able to deduct less interest expense from its CTI than the second business would despite the fact that both businesses incur the same "actual interest cost." *See* Appellee's Br. at 20. This so-called anomaly rests on the premise that both businesses should be treated similarly because they incur the same "actual interest cost," defined as interest expense netted with interest income. Once again, Taxpayer's argument rests on a debatable economic theory rather than on the language of the Regulation.

In fact, we believe that Taxpayer's reading of the Regulation would itself create an anomaly between two otherwise identically situated DISCs and their related suppliers. Suppose DISC #1 invested its temporary cash surplus in interest bearing securities while DISC #2 invested in dividend paying stock. Under Taxpayer's approach, DISC #1 and its related supplier would allocate interest expense to

interest income prior to allocating the remaining "net interest expense" to the income earned from the sale of export property. Meanwhile, DISC #2 and its related supplier would allocate the interest expense, unreduced by interest income, to the income earned from the sale of export property as well as to the dividends earned from the stock investment. Taxpayer's approach of allocating interest expense would result in a higher CTI in the first DISC and its related supplier than in the second, solely because of the nature of the investment of the surplus funds. Yet as discussed above, the Regulation is clear on its face that for purposes of determining CTI, investment of surplus funds in activities that produce income called interest should be treated no differently from investment in activities that produce income called dividends. Taxpayer attempts to justify this anomaly by pointing to differences, *inter alia*, in the level of risk involved in stocks versus bonds.[7] We note, first, that the onetime conventional wisdom that bonds are less risky than stocks seems no longer valid in the age of volatile interest rates, as vividly illustrated by the recent savings and loan debacles and the Orange County bankruptcy. In any case, Taxpayer's cited distinctions are irrelevant because they do not change the core fact that income from both stocks and bonds qualifies as income from income producing activities. The distinctions between the two types of securities fail to justify a judicially created exception to the Regulation's clear mandate that interest expense be allocated to all income producing activities.

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[7] Taxpayer notes that (1) stock dividends, unlike interest payments, are not guaranteed as to payment or timing; (2) stock prices can fluctuate widely, even over short time intervals, while debt generally will not; and (3) debt generally must be paid in full before stockholders recover in the event of financial difficulty.

Taxpayer argues that temporary regulation § 1.861-9T(a), issued after the tax years at issue here, also supports its position. The temporary regulation amends the language of the Regulation that was in effect during the relevant tax years, adding the sentence, "The term interest refers to the gross amount of interest expense incurred by a taxpayer in a given tax year." 26 C.F.R. § 1.861-9T(a) (1996). The amendment was made prospective only. We agree with the Commissioner that the temporary regulation merely reiterates, or clarifies, the Regulation at issue here, and find no merit to Taxpayer's argument that the temporary regulation substantially changed the rules for the apportionment of interest expense.

CONCLUSION

We conclude that Treasury regulation § 1.861-8(e)(2) of the 1978 regulations does not permit Taxpayer to increase the CTI of its DISCs and their related suppliers under 26 U.S.C. § 994, and thereby increase the income of its DISCs, which is subject to preferential tax treatment, by allocating interest expense to interest income and allocating only the balance to all other income producing activities.

The decision of the Tax Court is REVERSED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

GEORGE LANGE III
Clerk

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the 3rd day of March, one thousand nine hundred and ninety-seven.

PRESENT: HON. Amalya L. Kearse
HON. Pierre N. Leval
HON. William A. Norris*
Circuit Judges

Docket No: 96-4039

BOWATER INC. AND SUBSIDIARIES,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

[stamp—Filed, MAR 3 - 1997, United States Court of Appeals, Second Circuit, George Lange III, Clerk]

Appeal from United States Tax Court.

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* Honorable William A. Norris, of the United States Court of Appeals for the Ninth Circuit, sitting by designation.

This cause came on to be heard on the transcript of record from the United States Tax Court and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED, and DECREED that the judgment of said court be and it hereby is reversed in accordance with the opinion of this court.

For the Court
GEORGE LANGE III, Clerk

By: /s/ Beth J. Meador
Beth J. Meador
Administrative Attorney

[stamp—A TRUE COPY, GEORGE LANGE III, CLERK, /s/ George Lange III]

ISSUED AS MANDATE.
June 16, 1997 /init./ SM

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
UNITED STATES COURT HOUSE
40 FOLEY SQUARE
NEW YORK 10007

GEORGE LANGE III
Clerk

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, Foley Square, in the City of New York, on the Ninth day of June, one thousand nine hundred and ninety-seven.

Docket No.: 96-4039

Bowater, Inc. and Subsidiaries,
formerly known as Bowater Holdings, Inc.,
Petitioner-Appellee,

v.

Commissioner of Internal Revenue,
Respondent-Appellant.

[stamp—Filed, JUN 9 - 1997, United States Court of Appeals, Second Circuit, George Lange III, Clerk]

A petition for rehearing containing a suggestion that the action be *reheard in banc* having been filed herein by the petitioner *Bowater, Inc. and Subsidiaries,* and the panel that heard the appeal having filed an opinion on *March 3, 1997,*

IT IS HEREBY ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges for the court in regular

active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT,
George Lange III, Clerk
By:

/s/ Beth J. Meador
Beth J. Meador,
Administrative Attorney

APPENDIX D

UNITED STATES TAX COURT

101 T.C. No. 14

BOWATER INCORPORATED, F.K.A. BOWATER HOLDINGS, INC., AND SUBSIDIARIES, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 18436-91. Filed September 14, 1993.

Held, P may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing combined taxable income for P and its DISC under sec. 994(a)(2), I.R.C. 1954. *Dresser Industries, Inc. v. Commissioner,* 911 F.2d 1128 (5th Cir. 1990), revg. on this issue 92 T.C. 1276 (1989), distinguished.

Robert T. Carney, Alex Edward Medovich, John N. Tsigakos, Ecton R. Manning, and *John B. Glendon*, for petitioner.

Stephen M. Miller and *Meryl Silver*, for respondent.

[-2-] COLVIN, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax of $3,231,988 for 1976, $5,214,010 for 1979, and $27,096,396 for 1980.

The issue for decision is whether petitioner may net interest income against interest expense in determining the amount of the interest deduction to be allocated and apportioned in computing the combined taxable income (CTI) of petitioner and its domestic international sales corporations (DISC's). We hold that petitioner may.

As explained below, we distinguish *Dresser Industries, Inc. v. Commissioner*, 911 F.2d 1128 (5th Cir. 1990), revg. on this issue 92 T.C. 1276 (1989), because a regulation (sec. 1.861-8(e)(2), Income Tax. Regs.) applies here that did not apply in *Dresser Industries*.

The parties submitted this issue for decision on a fully stipulated basis. Other issues in this case will be tried or otherwise resolved in due course. Section references are to the Internal Revenue Code in effect for the years at issue. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

1. *Petitioner*

Bowater, Inc., F.K.A. Bowater Holdings, Inc., and Subsidiaries (petitioner), is a domestic corporation formed under the laws of Delaware. Petitioner's principal place of business was in Darien, Connecticut, when the petition was filed. During [-3-] petitioner's taxable years 1979 and 1980, its stock was wholly owned, directly or indirectly, by Bowater Corp., Ltd., a British corporation.

Petitioner and its subsidiaries filed consolidated Federal income tax returns for 1979 and 1980. Included in these returns were Bowater Southern Paper Corp. (Southern), and Bowater Carolina Corp. (Carolina). Carolina and Southern were wholly owned U.S. subsidiaries of petitioner.

2. *The Domestic International Sales Corporations*

Southern Export Corp. (Southern Export) was a wholly owned U.S. subsidiary of Southern. Carolina Export Co. (Carolina Export) was a wholly owned U.S. subsidiary of Carolina. Southern Export and Carolina Export qualified as DISC's throughout 1979 and 1980. They were accrual basis taxpayers and adopted fiscal years ending January 31. They

filed timely Federal income tax returns (Forms 1120-DISC) for their fiscal years ending in 1980 and 1981.

In 1979 and 1980, Southern Export and Carolina Export acted as commission agents for Southern and Carolina, respectively, in connection with the export sales of wood pulp and related products to customers outside of the United States and its possessions. Southern and Carolina computed the commissions paid to Southern Export and Carolina Export under the "50/50 combined taxable income" (CTI) method. Sec. 994(a)(2).

[-4-] In computing interest expense to be apportioned under sections 1.994-1(c)(6)(iii) and 1.861-8, Income Tax Regs., in the computation of the CTI of Southern and Carolina and their DISC's, petitioner allocated net interest expense (i.e., gross interest expense less gross interest income), as follows:

Amounts of Gross and Net Interest Expense

1979	*Carolina*	*Southern*
Gross interest expense	$1,036,575	$329,833
Gross interest income	932,151	184,627
Net Interest expense	104,424	145,206
1980		
Gross interest expense	1,332,345	544,906
Gross interest income	1,787,258	406,455
Net interest expense	(454,913)	138,451

The interest income of Southern and Carolina used to calculate net interest expense resulted primarily from the following procedure: sales proceeds from the sales of pulp and paper products sold by Carolina and Southern through their respective DISC's were collected by petitioner. Petitioner disbursed amounts to Carolina and Southern to cover their expenses. Petitioner retained the remainder for various

periods and treated it on the books of the respective companies as loans from Carolina and Southern to petitioner.[1]

[-5-] **OPINION**

1. *Background*

Congress enacted the DISC provisions (secs. 991-997) in 1971 to stimulate exports and to remove a tax disadvantage faced by U.S. firms exporting through domestic corporations. Revenue Act of 1971, Pub. L. 92-178, 85 Stat. 497; H. Rept. 92-533 (1971), 1972-1 C.B. 498, 502, 529; S. Rept. 92-437 (1971), 1972-1 C.B. 559, 565, 609. A qualifying DISC may defer part of the Federal tax on income from exports. However, the shareholders of a DISC are taxable currently on part of the profits and may generally defer taxation on the remaining part until the profits are withdrawn from the DISC or until the corporation ceases to qualify as a DISC. Secs. 995(a) and (b), 996(a)(1).

For a corporation to qualify as a DISC, at least 95 percent of its gross receipts must be qualified export receipts, and 95 percent of its assets must be qualified export assets. Secs. 992(a)(1), 993(a), (b), (f).

Section 994 provides intercompany pricing rules which are used to determine the price at which the parent corporation is deemed to have sold its products to the DISC. A DISC must use one of three intercompany pricing methods: (1) Four percent of qualified export receipts on the sale of export property; (2) 50 percent of the CTI of the DISC and

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[1] For purposes of this proceeding, the parties have stipulated that whether the retained amounts are bona fide loans is not an issue. Thus, we assume here that the loans have economic substance and were made on an arm's-length basis. We express no opinion about the result without this stipulation.

its supplier; or (3) the arm's-length price, computed in accordance with section 482. Sec. 994(a). The 50-percent method is at issue in this case. [-6-] Sec. 994(a)(2). It allows a DISC to earn taxable income of 50 percent of the CTI of a DISC and its supplier which is attributable to qualified export receipts derived from the sale by the DISC of export property plus 10 percent of export promotion expenses of the DISC attributable to those receipts.

2. *Treatment of Interest Expense for Computing CTI*

We must decide whether petitioner may net interest income against interest expense in determining the amount of interest deductions to be allocated and apportioned in computing the CTI of Southern, Carolina, and their DISC's. Petitioners have a larger CTI and a larger DISC tax benefit if they are permitted to net interest income against interest expense.

CTI is determined generally in accordance with the principles applicable under section 861. H. Rept. 92-533, *supra*, 1972-2 C.B. at 538. The legislative history provides:

> the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country. These rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis. Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property,

> the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to be determined on the basis of the ratio of the combined gross income from [-7-] the export property to the total gross income of the related person and the DISC. [Fn. ref. omitted.]

See also S. Rept. 92-437, *supra*, 1972-1 C.B. at 619. The Congressional reference to section 861 also appears in the DISC regulations:

> (iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in § 1.861-8. Sec. 1.994-1(c)(6)(iii), Income Tax Regs.

3. *Fungibility of Money and Section 1.861-8(e)(2), Income Tax Regs.*

For purposes of section 861, interest is assumed to be fungible. Sec. 1.861-8(e)(2), Income Tax Regs. These regulations are based on the theory that all of a taxpayer's activities and assets need funds and that a taxpayer has great flexibility as to the source and use of funds. See Isenbergh, International Taxation, par. 6.8.1, at 205 (1990); Kuntz & Peroni, U.S. International Taxation, par. A2.05(5)(a), at A2-202 and 203 (1992). Section 1.861-8(e)(2), Income Tax Regs., was adopted on January 3, 1977, effective for taxable years beginning after December 31, 1976. It states:

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense * * *

(2) *Interest*—(i) *In general.* The method of allocation and apportionment for interest set forth [-8-] in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes. * * *

(ii) *Allocation of interest.* Except as provided in subdivisions (iii) and (iv) of this subparagraph, the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

Both parties contend that this regulation applies here and that it favors their respective positions. At the same time, both parties recognize that this regulation does not expressly state whether or not netting of interest is allowed.

Dresser Industries, Inc. v. Commissioner, 911 F.2d 1128 (5th Cir. 1990), revg. on this issue *Dresser Industries, Inc. v. Commissioner*, 92 T.C. 1276 (1989), decided a form of this issue as it arose in an earlier year. That case is distinguishable because section 1.861-8(e)(2), Income Tax Regs., applies here, but did not apply to the years before the Court in *Dresser Industries*. *Dresser Industries* dealt with the taxpayer's taxable years 1976 and 1977, which began on November 1, 1975, and [-9-] November 1, 1976. *Dresser Industries, Inc. v. Commissioner*, 92 T.C. at 1276. Section 1.861-8(e)(2), Income Tax Regs., was first effective for taxable years beginning after 1976. Thus, it did not apply in that case. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1134-1135. In contrast, the parties agree that the regulation applies here.

We believe petitioner's argument for netting interest expense and interest income is similar to the fungibility concept in the regulation because both focus on underlying economic realities. Netting of interest avoids unequal treatment of taxpayers with the same amount of actual interest cost, just as the fungibility of interest concept avoids unequal treatment of taxpayers whose indebtedness is structured differently.[2] As the Court of Appeals for the Fifth Circuit said in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1135:

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[2] In *St. Jude Medical Inc. v. Commissioner*, 97 T.C. 457, 481 (1991), we rejected the taxpayer's contention that we should decide the case based on economic reality. In that case, the taxpayer contended that sec. 1.861-8(e)(3), Income Tax Regs., was invalid and that it led to a result at odds with economic reality. That regulation did not apply a fungibility concept. In contrast, here, the regulation's fungibility approach suggests that consideration of economic reality should govern in deciding this case.

> Rarely, if ever, do the amount and timing of business borrowing directly correlate to specific investments. For instance, a business might borrow sufficient funds to finance its operations for the coming quarter. The business typically incurs the debt in a single transaction, even though its cash requirements are spread out over the ensuing three months. As a result, the business will have at least some borrowed funds on [-10-] hand that are not required immediately but which may be required in the near future. To reduce the cost of holding these funds until they are actually needed, the business might invest in short-term, interest bearing instruments. * * * Alternatively, a business might decide to finance its operations by issuing long-term bonds or other securities. Because it may be impractical to retire these obligations prior to their maturity, the business will typically invest any cash surplus to offset the cost of carrying its long-term debt. * * * In either case, the total *cost of the borrowing* is the interest expense on the debt incurred, reduced by the interest earned on the investment of any temporary cash surplus.

Respondent contends that interest income is not attributable to qualified export receipts. That contention is not persuasive because it assumes its own conclusion: that interest income should be considered separately, and not netted with interest expense.[3] Respondent's position of requiring alloca-

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[3] Even though sec. 1.861-8(e)(2), Income Tax Regs., did not apply to the years in *Dresser Industries, Inc. v. Commissioner*, 92 T.C. 1276 (1989), revd. on this issue 911 F.2d 128 (5th Cir. 1990), both the Tax Court and the Court of Appeals for the Fifth Circuit discussed it in dicta. Notwithstanding that discussion, the regulation was not effective for the years before the Court in *Dresser Industries*. In our opinion in *Dresser Industries*, we said that sec. 1.861-8(e)(2), Income Tax Regs., "does not provide for the netting of interest income and expense before allocation and apportionment." *Dresser Industries, Inc. v. Commissioner*, 92 T.C.

tion of gross interest expense would burden a DISC with a disproportionate [-11-] share of the actual borrowing costs of all operations. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1136.

Respondent asserts that the only exception in the regulations to fungibility is stated in section 1.861-8(e)(2)(iv), Income Tax Regs., which does not apply here. Section 1.861-8(e)(2)(iv)(B), Income Tax Regs., provides in part:

> (B) Where an interest deduction is definitely related solely to specific property under (A) of this subdivision (iv), such interest deduction and such property, or the portion thereof, to which such interest deduction relates shall not be included in the allocation described in subdivision (ii) of this paragraph (e)(2). * * *

We agree that this provision applies only to interest expense allocable to specific property. However, regardless of this exception, we believe that netting is consistent with the fungibility approach taken in section 1.861-8(e)(2), Income Tax Regs. *Dresser Industries, Inc. v. Commissioner, supra* at 1135.

4. *Net Interest Expense Is the Actual Cost of Interest*

Net interest expense is the actual cost of borrowing; the total cost of borrowing is the interest expense on the debt incurred, reduced by the interest earned on the investment of

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at 1286. We did not discuss why the absence of a rule specifically related to netting should be construed to prohibit or allow netting. As discussed in this opinion, we conclude that, in the absence of a rule resolving the issue, netting is consistent with the fungibility concept in sec. 1.861-8(e)(2), Income Tax Regs., and with analogous precedents which allow netting, such as *General Portland Cement v. United States*, 628 F.2d 321 (5th Cir. 1980), and *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352 (1984).

any temporary cash surplus. *General Portland Cement Co. v. United States*, 628 F.2d 321, 344 (5th Cir. 1980); *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. 352, 402 (1984). The issue in those cases is analogous to the issue here. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1133-1136, 92 T.C. at 1284. Section 613(a) provides a deduction for percentage [-12-] depletion limited to 50 percent of the taxpayer's taxable income from mining property. In computing taxable income, the taxpayer may reduce gross income by allowable deductions attributable to the mining process, including "financial overhead." Sec. 1.613-5(a), Income Tax Regs. In computing "financial overhead", the taxpayer may net interest expense and interest income. *General Portland Cement Co. v. United States, supra; Ideal Basic Industries, Inc. v. Commissioner, supra.* The Court of Appeals for the Fifth Circuit relied on these cases in reversing our decision in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1133-1136. In *General Portland Cement Co. v. United States, supra* at 344, the Court of Appeals reasoned:

> We think the purpose behind the "50% limit" argues in favor of the taxpayer in the instant case. We believe that purpose is served by subtracting the *actual* cost of interest, rather than an inflated amount. Taxpayer's actual cost of interest is its "net" interest expense.

The Court of Appeals relied on the fungibility concept as the underlying principle to decide that case. *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1135. These cases support petitioner's position because of the close logical relationship to the netting issue here.

Respondent argues that *General Portland Cement* is distinguishable because in it, unlike in this case, there was an investment of a temporary cash surplus from the borrowed funds. That basis for distinction is not persuasive in the

context of fungibility of interest. As noted earlier, respondent does not [-13-] dispute that the loans are bona fide.[4] We see no economic difference, and the parties point to none, among interest earned on the investment of surplus funds from short-term Treasury bills and commercial paper in *General Portland Cement Co. v. United States*, 628 F.2d at 343, short-term, highly liquid commercial paper in *Ideal Basic Industries, Inc. v. Commissioner*, 82 T.C. at 400, unspecified investments in *Dresser Industries, Inc. v. Commissioner*, 911 F.2d at 1130, and bona fide loans to related parties as in this case. In all of these situations net interest is the actual cost of borrowing.

We recognize that in other situations a taxpayer may not net interest income and expense. For example, in *Murphy v. Commissioner*, 92 T.C. 12, 14-15 (1989), a taxpayer who claimed the standard deduction was not allowed to net interest income and expenses because netting would circumvent the limitation of the deduction of personal interest to individuals who itemize their tax deductions. This consideration is not present in the percentage depletion or DISC contexts.

After disposition of the remaining issues in this case, decision will be entered under Rule 155. With respect to disposition of the remaining issues,

An appropriate order will be issued.

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[4] See *supra* note 1.

APPENDIX E

UNITED STATES TAX COURT

Docket No. 18436-91

BOWATER INCORPORATED (FORMERLY BOWATER HOLDINGS, INC.) AND SUBSIDIARIES

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinions of the Court filed April 10, 1995, and September 14, 1993, and incorporating herein the facts recited in the respondent's computation as the finding of the Court, it is

ORDERED and DECIDED:

That there is a deficiency in income tax due from the petitioner for the taxable year 1976 in the amount of $553,544; That there is a deficiency in withholding tax due from the petitioner for the taxable year 1979 in the amount of $119,368;

That there is a statutory deficiency in income tax, computed without allowance for business energy investment credit carryback, due from the petitioner for the taxable year 1979 in the amount of $2,845,151, and that there is an overpayment in income tax, computed after allowance for business energy investment credit carryback, for the taxable year 1979 in the amount of $1,250,000, which amount was paid on January 31, 1994 after the mailing of the notice of deficiency;

That there is a deficiency in withholding tax due from the petitioner for the taxable year 1980 in the amount of $152,717; and

That the following statement shows the petitioner's income tax liability for the taxable year 1980:

	1980
Tax Liability, computed without allowance for investment credit, job credit and research credit carrybacks from 1982 and 1983 to 1980	$ 26,176,766
Tax Assessed and Paid	2,350,646
Deficiency to be assessed, without allowance for investment, jobs and research credit carrybacks	$ 23,826,120
Reduction in liability due to investment, jobs and research credit carrybacks	20,008,389
Deficiency to be assessed, after allowance for investment, jobs, and research credit carrybacks	$ 3,817,731
Tax liability, computed without allowance for investment credit, jobs credit and research credit from 1982 to 1983 to 1980	$ 26,176,766
Net Tax Paid	4,200,646
Deficiency to be paid, without allowance for investment, jobs and research credit carrybacks	$ 21,976,120
Reduction in liability due to investment, jobs and research credit carrybacks	20,008,389
Deficiency to be paid, after allowance for investment, jobs and research credit carrybacks	$ 1,967,731

Entered: DEC 4 1995

(Signed) ARNOLD RAUM
Judge

It is hereby stipulated that the foregoing decision is in accordance with the opinions of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

STUART L. BROWN
CHIEF COUNSEL
INTERNAL REVENUE SERVICE

/s/ Robert T. Carney
ROBERT T. CARNEY
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607 14TH STREET, NW
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TAX COURT NO. MS0240

APPENDIX F

STATUTES AND REGULATIONS

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 861. Income From Sources Within the United States

[Sec. 861(a)]

(a) Gross Income From Sources Within United States.—

* * *

(b) Taxable Income From Sources Within United States.—From the items of gross income specified in subsection (a) as being income from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as taxable income from sources within the United States. In the case of an individual who does not itemize deductions, an amount equal to the standard deduction shall be considered a deduction which cannot definitely be allocated to some item or class of gross income.

Sec. 994. Inter-company pricing rules

(a) In general.—In the case of a sale of export property to a DISC by a person described in section 482, the taxable income of such DISC and such person shall be based upon a transfer price which would allow such DISC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 4 percent of the qualified export receipts on the sale of such property by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts,

(2) 50 percent of the combined taxable income of such DISC and such person which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC plus 10 percent of the export promotion expenses of such DISC attributable to such receipts, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482). . . .

Treasury Regulations on Income Tax (26 C.F.R.) (1978):

Reg. § 1.861-8 Computation of Taxable Income From Sources Within the United States and From Other Sources and Activities.

(a) *In general.*—

(1) *Scope.* Sections 861(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined. Sections 862(b) and 863(a) state in general terms how to determine taxable income of a taxpayer from sources without the United States after gross income from sources without the United States has been determined. This section provides specific guidance for applying the cited Code sections by prescribing rules for the allocation and apportionment of expenses, losses, and other deductions (referred to collectively in this section as "deductions") of the taxpayer. . . .

(2) *Allocation and apportionment of deductions in general.* A taxpayer to which this section applies is required to allocate deductions to a class of gross income and, then, if necessary to make the determination required by the operative section of the Code, to apportion deductions within the class of gross income

between the statutory grouping of gross income (or among the statutory groupings) and the residual grouping of gross income. Except for deductions, if any, which are not definitely related to gross income (see paragraphs (c)(2) and (e)(9) of this section) and which, therefore, are ratably apportioned to all gross income, all deductions of the taxpayer (except deductions for personal exemptions enumerated in paragraph (e)(11) of this section) must be so allocated and apportioned. . . .

(3) *Class of gross income.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items (or subdivisions of these items) of gross income enumerated in section 61 . . . .

* * *

(5) *Effective Date.* The provisions of this section shall be applicable to taxable years beginning after December 31, 1976. . . .

(b) *Allocation.*

(1) *In general.* For purposes of this section, the gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. . . . Allocation is accomplished by determining, with respect to each deduction, the class of gross income to which the deduction is definitely related and then allocating the deduction to such class of gross income. . . . Although most deductions will be definitely related to some class of a taxpayer's total gross income, some deductions are

related to all gross income. In addition, some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income. . . .

* * *

(4) *Deductions related to a class of gross income.* See paragraph (e) of this section for rules related to the allocation and apportionment of certain specific deductions definitely related to a class of gross income. See paragraph (c)(1) for rules relating to the apportionment of deductions.

(c) *Apportionment of deductions*—(1) *Deductions definitely related to a class of gross income.* Where a deduction has been allocated in accordance with paragraph (b) of this section to a class of gross income which is included in one statutory grouping and the residual grouping, the deduction must be apportioned between the statutory grouping and the residual grouping. . . .

Paragraphs (e)(2) through (e)(8) of this section provide the applicable rules for allocation and apportionment of deductions for interest, research, and development expenses, and certain other deductions. . . .

* * *

(e) *Allocation and apportionment of certain deductions*—(1) *In general.* Subparagraphs (2) and (3) of this paragraph contain rules with respect to the allocation and apportionment of interest expense and research and development expenditures, respectively. . . .

(2) *Interest*—(i) *In general.* The method of allocation and apportionment for interest set forth in this paragraph (e)(2) is based on the approach that money is fungible and that interest expense is attributable to all activities and property regardless of any specific pur-

poses for incurring an obligation on which interest is paid. This approach recognizes that all activities and property require funds and that management has a great deal of flexibility as to the source and use of funds. Normally, creditors of a taxpayer subject the money advanced to the taxpayer to the risk of the taxpayer's entire activities and look to the general credit of the taxpayer for payment of the debt. When money is borrowed for a specific purpose, such borrowing will generally free other funds for other purposes and it is reasonable under this approach to attribute part of the cost of borrowing to such other purposes.

(ii) *Allocation of interest.* Except as provided in subdivisions (iii) and (iv) of this subparagraph, the aggregate of deductions for interest shall be considered related to all income producing activities and properties of the taxpayer and, thus, allocable to all the gross income which the income producing activities and properties of the taxpayer generate, have generated, or could reasonably have been expected to generate.

* * *

(v) *Apportionment of interest—asset method.* Normally, the deduction for interest expense relates more closely to the amount of capital utilized or invested in an activity or property than to the gross income generated therefrom, and therefore the deduction for interest should normally be apportioned on the basis of asset values. Indebtedness permits the taxpayer to acquire or retain different kinds of assets which may produce substantially different yields of gross income in relation to their value. Thus, apportionment of an interest deduction on such basis as gross income may not be reasonable. If a taxpayer consistently apportions the deduction for interest on

the basis of the tax book value (original cost for tax purposes less depreciation allowed for tax purposes) of its assets, that method will ordinarily be accepted. Alternatively, if a taxpayer can apportion the deduction on the basis of the fair market value of his assets and he can establish the fair market value to the satisfaction of the Commissioner, that method will also be acceptable. However, once the taxpayer uses fair market value the taxpayer must continue to use such method unless expressly authorized by the Commissioner to change his method.

* * *

(f) *Miscellaneous matters*—(1) *Operative sections.* The operative sections of the Code which require the determination of taxable income of the taxpayer from specific sources or activities and which give rise to statutory groupings to which this section is applicable include the sections described below. . . .

* * *

(iii) *DISC taxable income.* Section 994 provides rules for determining the taxable income of a DISC with respect to qualified sales and leases of export property and qualified services. The "50-50" combined taxable income method available for making such determination provides, without consideration of export promotion expenses, that the taxable income of the DISC shall be 50 percent of the combined taxable income of the DISC and the related supplier derived from such sales and leases of export property and such services. . . .

* * *

Reg. § 1.994-1 Inter-Company Pricing Rules for DISC'S.

* * *

(c) *Transfer price for sales of export property.*

(1) *In general.* Under this paragraph, rules are prescribed for computing the allowable price for a transfer from a related supplier to a DISC in a case of a sale of export property described in paragraph (b)(1) of this section.

* * *

(3) *The "50-50" combined taxable income method.* Under the combined taxable income method of pricing, the transfer price for a sale by the related supplier to the DISC is the price as a result of which the taxable income derived by the DISC from the sale will not exceed the sum of (i) 50 percent of the combined taxable income (as defined in subparagraph (6) of this paragraph) of the DISC and its related supplier attributable to the qualified export receipts from such sale and (ii) 10 percent of the export promotion expenses (as defined in subparagraph (f) of this section) of the DISC attributable to such qualified export receipts.

* * *

(6) *Combined taxable income.* For purposes of this section, the combined taxable income of a DISC and its related supplier from a sale of export property is the excess of the gross receipts (as defined in section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which related to such gross receipts. Gross receipts from a sale do not include interest with respect to the sale. Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) all adjustments required by section 482 with respect to transactions to which such section is applicable. In determining

the gross receipts of the DISC and the total costs of the DISC and related supplier which relate to such gross receipts, the following rules shall be applied:

* * *

(iii) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of any other expenses, losses, or other deductions which are not definitely related to a class of gross income, determined in a manner consistent with the rules set forth in Treas. Reg. § 1.861-8.

* * *

APPENDIX G

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, DC 20543-0001

William K. Suter
Clerk of the Court

Area Code 202
479-3011

August 26, 1997

Mr. Albert G. Lauber Jr.
Caplin & Drysdale, Chtd.
#1100, One Thomas Circle, N.W.
Washington, DC 20005

Re: Bowater, Inc. and Subsidiaries
v. Commissioner of Internal Revenue
Application No. A-157

Dear Mr. Lauber:

The Application for an extension of time within which to file a petition for a writ of certiorari in the above-entitled case has been presented to Justice Ginsburg, who on August 26, 1997, extended the time to and including October 7, 1997.

This letter has been sent to those designated on the attached notification list.

Sincerely,

William K. Suter, Clerk

By /s/
Melissa A. Blalock
Assistant Clerk

SUPREME COURT OF THE UNITED STATES
OFFICE OF THE CLERK
WASHINGTON, DC 20543-0001

William K. Suter
Clerk of the Court

Area Code 202
479-3011

NOTIFICATION LIST

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Hon. Walter Dellinger
Acting Solicitor General
Department of Justice
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